ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Vanguard Shutters Capital Value

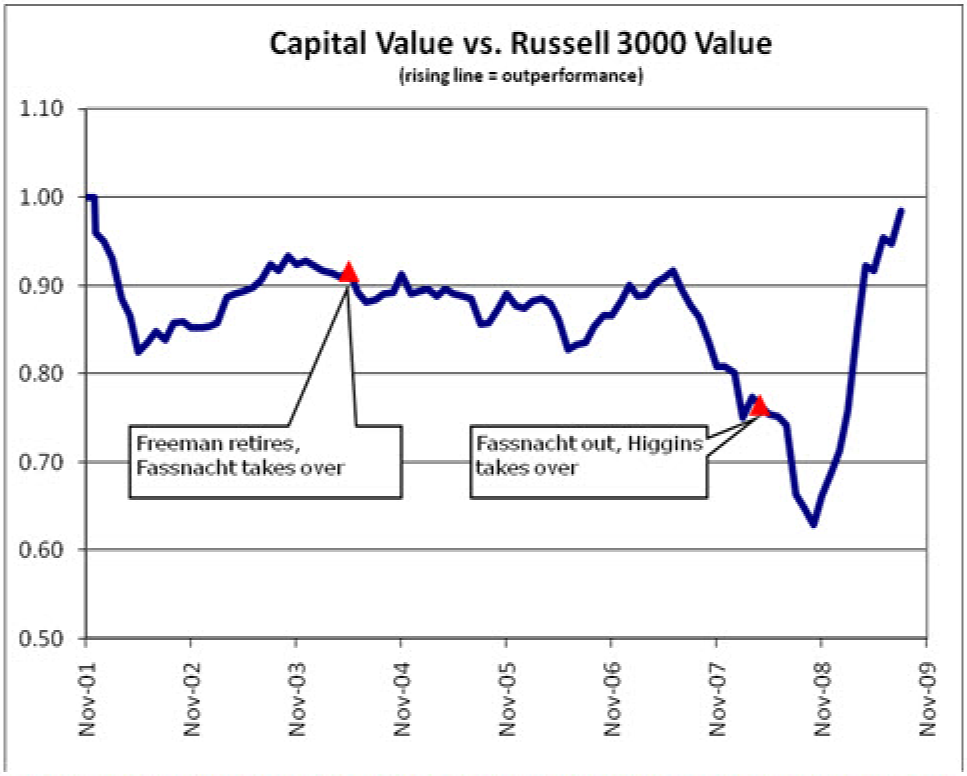
On October 9th, Vanguard announced that the firm's top-performing fund so far in 2009, Capital Value, was closing to new investors, effective immediately. Existing investors will be permitted to add to their holdings, however. The firm cited the rapid increase of the size of the fund, which has tripled its assets since February with strong cash inflows and capital appreciation, as the reason for the closure.

Vanguard claims that the fund's swelling from $257 million in assets under management as of the end of January to the $742 million at the end of September was not a problem for manager Peter Higgins and his strategy, but rather that the "cooling off" period is designed to protect investors who are chasing performance (the fund was up 76.3% for the year through October 14). But we're not fully convinced that this is the true reason for the closure.

In February and March, Capital Value saw asset outflows of about $10 million, followed by inflows of $250 million over the next six months. By contrast, Emerging Markets Index saw outflows of $1.1 billion in February and March, followed by inflows of $5.9 billion over the next six months (Emerging Markets Index is up 73.9% for the year through October 14, not far behind Capital Value). Given Emerging Markets Index's historically volatile performance record (the fund lost 60.1% over the 13 months ending in November 2008, for example), it could be argued that investors there might need some protection as well, especially since the amount of money at stake is much greater.

Vanguard never seems to close funds to "protect investors from themselves" when the funds in question are of the index variety, such as 500 Index or Emerging Markets Index, but they do when it's an active fund, which raises the question of whether they were truly being up front when they told *The Wall Street Journal* on October 5th, four days before shutting Capital Value down, that there were no problems for the manager in dealing with increased cash flows.

But whatever Vanguard's reasoning, we are not convinced that this closure is necessarily a bad thing for investors. Capital Value, until November 2008, has had a rather unimpressive performance history, which you can see in the chart below. Compared to its Russell 3000 Value Index benchmark, the fund has failed to outperform the index for any sustained period of time. This was part of the reason for Peter Higgins's appointment as manager in June 2008, when he replaced David Fassnacht, who had been managing the fund solo since June 2004.



Note: Each 0.10 rise or drop in the line charted above represents 10% outperformance or underperformance, respectively, of Capital Value over its Russell 3000 Value Index benchmark.

In Higgins's brief tenure on the fund, he has certainly made his mark, and not only on performance. While the traditional deep value investor follows a longer-term buy-and-hold strategy, buying underpriced companies and then selling them down the line once they have grown in value to a predetermined price. Higgins has taken a far more aggressive approach, however. Under his supervision, the fund has increased its annualized turnover rate from the 40% to 56% range under its first two managers to a whopping 413% over the first six months of the fund's current fiscal year (which ended in September). This means that Higgins bought and sold shares worth more than four times the worth of the entire portfolio over that period.

While the closing of the fund makes the point somewhat moot, despite Capital Value's meteoric rise, we were not convinced that it was a suitable investment for our clients' portfolios. We've been watching the fund closely this year, but until we see signs that Higgins's management style can lead the fund to sustained long-term outperformance, we would have a hard time taking money away from the managers with proven track records in our client portfolios to invest in this fund.

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